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No. 82-1943

In the Supreme Court of the United States

OCTOBER TERM, 1982

JOSEPH GANN, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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TABLE OF AUTHORITIES

Page

Cases:

Helvering v. *Campbell*, 313 U.S. 15 3

Helvering v. *Rankin*, 295 U.S. 123 3

Helvering v. *Winmill*, 305 U.S. 79 4

Keeler v. *Commissioner*, 86 F.2d 265 3

Kluger Associates, Inc. v. *Commissioner*, 617 F.2d 323 3

Skinner v. *Eaton*, 45 F.2d 568, cert. denied, 283 U.S. 837 3

Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522 ..... 4, 5

United States v. *Correll*, 389 U.S. 299 4

Vawter v. *Commissioner*, 83 F.2d 11 3

Statute and regulations:

Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)):

Section 446 ..... 2, 3, 4
Section 446(a) 4
Section 446(b) 4
Section 1012 4
Section 1372 (& Supp. V) 1
Section 1372(e)(5) 1, 2
Section 1372(e)(5)(C) 1

Treas. Reg. 33, Art. 4, para. 60 (1918) 3

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) Section 1.1012-1(c)(1) 1, 2, 3

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Petitioner challenges the validity of Treasury Regulations on Income Tax (1954 Code), Section 1.1012-1(c)(1) (26 C.F.R.), which provides that when a taxpayer sells stock without identifying which of several lots, purchased at different times and prices, has been sold, it will be presumed that the stock sold is the stock first acquired.

Petitioner, a corporation engaged in the sale of jewelry, elected (for its taxable years beginning after November 1, 1971) to be taxed as a small business (Subchapter S) corporation, pursuant to Section 1372 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)).[1] Between 1966 and

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[1]Subchapter S corporations have no income tax liability; their income is taxed directly to their shareholders. In order to maintain Subchapter S status, however, a corporation must not have "passive investment income" in excess of 20% of its gross receipts. See Section 1372(e)(5) of the 1954 Code. The term "passive investment income" includes gain on the sale of stock (Section 1372(e)(5)(C)).

1973, petitioner made a number of purchases of stock in Bearings, Inc., a publicly traded corporation. By 1973, petitioner owned more than 10,000 shares of Bearings stock. During its fiscal year ending October 31, 1973, petitioner sold 4,000 shares of that stock. Petitioner, however, maintained no records identifying which lots of Bearings stock it had sold. It calculated its gain on the sale for income tax purposes using the same "average [redacted] cost" method it used in keeping its books.[2] Using this average [redacted] cost method to compute the basis of the Bearings stock sold, petitioner's "passive investment income" pursuant to Section 1372(e)(5) of the 1954 Code, for its taxable year ended October 31, 1973 was 19.06% of petitioner's gross receipts (Pet. App. 17).

On audit, the Commissioner redetermined the gain realized by petitioner on the sale of the 4,000 shares, pursuant to the first-in, first-out (FIFO) method prescribed by Treasury Regulations on Income Tax (1954 Code), Section 1.1012-1(c)(1) (26 C.F.R.). Under the FIFO method, petitioner's passive investment income for its taxable year 1973 was 20.87% of its gross receipts for that year. Since petitioner's passive income exceeded 20% of its gross receipts, its Subchapter S election was terminated giving rise to the income tax deficiencies in question (Pet. App. 11, 18).

In the Tax Court, petitioner maintained that, pursuant to Section 446 of the 1954 Code, it was entitled to use the average cost method in computing its gain because it employed that method in keeping its books, and because the Commissioner did not determine that that method did not clearly reflect income.[3] It further contended that the

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[2]Petitioner divided the total cost of the shares by the number of shares owned and used the resulting average cost per share in computing the gain realized on the sale of the 4,000 shares (Pet. App. 17).

[3]Section 446 of the Internal Revenue Code of 1954 (26 U.S.C.), provides in relevant part:

> (a) Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books * * * [;] (b) * * * if the method

FIFO rule contained in Treasury Regulations, Section 1.1012-1(c)(1) (26 C.F.R.) conflicts with Section 446 of the 1954 Code and therefore is invalid. The Tax Court rejected petitioner's contentions. It found no conflict between the general rule stated in Section 446 and the requirement in the regulation that the cost of unidentifiable shares be determined using the FIFO method. The court of appeals affirmed (Pet. App. 10-13).

The decisions below are correct, and further review by this Court is not warranted.

1. The FIFO rule, now embodied in Treasury Regulations, Section 1.1012-1(c)(1) (26 C.F.R.), was first adopted in regulations promulgated in 1918 under the Revenue Act of 1916 (Treas. Reg. 33, Art. 4, para. 60 (1918)) and has been carried forward under every succeeding revenue act. See *Kluger Associates, Inc.* v. *Commissioner*, 617 F.2d 323, 326 (2d Cir. 1980). In all this time, the validity of the FIFO principle has never been seriously questioned. On the contrary, the courts, including this Court, have expressly approved the rule. *Helvering* v. *Rankin*, 295 U.S. 123, 129 (1935); *Skinner* v. *Eaton*, 45 F.2d 568, 570 (2d Cir. 1930), cert. denied, 283 U.S. 837 (1931); *Vawter* v. *Commissioner*, 83 F.2d 11, 13 (10th Cir. 1936); *Keeler* v. *Commissioner*, 86 F.2d 265 (8th Cir. 1936). It was applied by this Court in *Helvering* v. *Campbell*, 313 U.S. 15, 20-21 (1941).

Moreover, as correctly pointed out by the court of appeals (Pet. App. 11), the long-standing FIFO principle must be deemed to have achieved the effect of law under the

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used does not clearly reflect income, the computation of taxable income shall be made under [a method determined by the Secretary] * * * [;] (c) [Permissible methods include] * * * (1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

well-settled principle that " 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' " *United States* v. *Correll*, 389 U.S. 299, 305-306 (1967), quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938).

There is no conflict between the regulation and Section 446 of 1954 Code. As the Tax Court explained (Pet. App. 21), Section 446(a) provides a general rule that is not controlling where a more specific section of the 1954 Code is applicable or where, as provided by Section 446(b), the Commissioner requires other methods that clearly reflect income. Here Section 1012 of the 1954 Code provides that the basis of property shall be its cost. The regulation properly implements that Section by providing a means for identifying the shares whose cost is to be taken into account on a sale. The average cost method employed by petitioner in keeping its books does not comport with the requirements of Section 1012 since that method does not reflect the actual cost of any specific shares.

2. There is no merit to petitioner's argument (Pet. 8-9) that the court of appeals erred in applying the regulation because petitioner's use of the average cost method was in conformity with generally accepted accounting principles. This Court has rejected the argument that Section 446 creates a presumption in favor of a taxpayer's method of accounting merely because that method is in conformity with generally accepted accounting principles. In *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 538-540 (1979), the court stated that even if there were a general presumption in favor of allowing taxpayers to use any method of accounting that conforms with generally accepted accounting principles, the presumption must yield when the method used is inconsistent with a valid regulation

adopted by the Commissioner, prescribing or limiting the method of accounting to be used for tax purposes for reporting a particular type of transaction. As the court of appeals below held (Pet. App. 13), the Commissioner has adopted specific regulations having the force of law requiring the use of FIFO for computing the cost basis of shares of stock when the particular shares sold have not been otherwise adequately identified. Petitioner's claim that its use of a different method is in conformity with generally accepted accounting principles is accordingly unavailing. *Thor Power Tool Co.* v. *Commissioner, supra*, 439 U.S. at 543-544.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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